

# Expert Q&A on Structured Dismissals and the US Supreme Court's Decision in Jevic

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## An Expert Q&A with Bradford J. Sandler of Pachulski Stang Ziehl & Jones LLP discussing his views on structured dismissals as a means of exiting a Chapter 11 case and the impact the US Supreme Court's decision in *Czyzewski v. Jevic Holding Corp* is likely to have on future structured dismissals.

An increasingly more common exit strategy in Chapter 11 cases is the use of structured dismissals. While structured dismissals are not explicitly provided for in the Bankruptcy Code, they act an alternative exit strategy when a debtor is generally insolvent or unable to confirm a Chapter 11 plan with the proper support from various creditor groups. On March 22, 2017, in *Czyzewski v. Jevic Holding Corp.*, the US Supreme Court reversed the Third Circuit and ruled in a 6-2 decision that bankruptcy courts cannot approve structured dismissals that violate the priority rules set out in the Bankruptcy Code without the affected creditors' consent, even in rare cases (2017 WL 1066259 (U.S. Mar. 22, 2017)).

Practical Law asked Bradford J. Sandler of Pachulski Stang Ziehl & Jones LLP for his thoughts on structured dismissals as a means of exiting a Chapter 11 case and the impact the US Supreme Court's decision in *Czyzewski v. Jevic Holding Corp* is likely to have on the future of structured dismissals.

### WHAT IS A STRUCTURED DISMISSAL AND WHY DO PRACTITIONERS USE THEM AS A MEANS OF EXITING A CHAPTER 11 CASE?

A structured dismissal is a hybrid between a plan and a simple dismissal order. The Bankruptcy Code explicitly provides for several ways to exit Chapter 11, including confirmation of a plan of reorganization or liquidation, conversion from Chapter 11 to Chapter 7, or a dismissal (see Practice Note, Chapter 11 Exit Strategies: Overview ([w-000-7391](#))). While practitioners and judges often feel that the most elegant way to exit Chapter 11 is by using a plan, the cost of

drafting, negotiating, soliciting creditor support, and obtaining court approval of a plan is typically expensive because it involves substantial professional and administrative fees. There are also numerous substantive and procedural requirements that must be met to confirm a plan. For example, section 1129 of the Bankruptcy Code provides, among other things, that:

- All administrative priority creditors must be paid in full, subject to certain exceptions.
- All distributions must be paid according to the priority scheme in section 507 of the Bankruptcy Code and must treat any impaired, non-consenting class fairly and equitably (see Practice Note, Chapter 11 Plan Process: Overview: Confirmation of a Plan: Cramdown Plans ([0-502-7396](#))).

Despite the hurdles of the plan process, management and other parties in interest, such as directors, lenders, and acquirers, often prefer the plan process because they can obtain certain protections, subject to acceptance by the creditor body and approval of the court, such as releases, exculpation provisions, and settlements. However, as the cost of obtaining plan approval continues to increase since the Bankruptcy Code was first enacted, bankruptcy practitioners have sought to find creative ways to provide the same customary protections contained in a plan in a more cost-effective Chapter 11 exit vehicle. That vehicle became the structured dismissal.

A structured dismissal is often proposed:

- In the context of or promptly following a section 363 sale of substantially all of the debtor's assets (see Practice Note, Buying Assets in a Section 363 Bankruptcy Sale: Overview ([1-385-0115](#))).
- After or in connection with a global settlement sought to be approved under Federal Rule of Bankruptcy Procedure 9019 (see Practice Note, Rule 9019 Settlements ([w-000-9618](#))).

The Bankruptcy Code provides for dismissal of a case under sections 1112(b) and 305(a). While those sections state the grounds and cause for a dismissal, section 349 of the Bankruptcy Code explains the effects of a dismissal. Under section 349, unless "the court, for cause, orders otherwise," a dismissal reinstates the debtor and parties' respective positions as if the bankruptcy case was never filed. When seeking approval of a structured dismissal, parties rely on these statutory provisions but depend on and emphasize the quoted

language seeking to have the bankruptcy court “order otherwise” so that the parties are not brought back to their prepetition state. A structured dismissal generally provides that all prior orders of the bankruptcy court remain in full force and contain various releases, exculpation provisions, settlements, claim reconciliation procedures, and distribution schemes (see Practice Note, Chapter 11 Exit Strategies: Overview: Structured Dismissals ([w-000-7391](#))). In certain cases, the distribution scheme may or may not respect the priorities of the Bankruptcy Code set out in section 507. This is one of the primary controversies of structured dismissals.

While structured dismissals that respect the priorities in the Bankruptcy Code are typically not controversial (with the exception of the US Trustee, which generally objects on policy grounds), structured dismissals that violate the absolute priority rule often generate significant objections. Over the last decade, as asset values have been declining and companies have taken on more debt, creditors continuously find that there is insufficient value to fully pay the debtor's secured debt, administrative creditors, and priority creditors and then fund a plan process that provides a recovery to general unsecured creditors. The 2005 amendments to the Bankruptcy Code exacerbated this problem with the enactment of section 503(b)(9) of the Bankruptcy Code, which added an additional layer of administrative claims that must be paid if a company intended to exit bankruptcy under a plan (see Practice Note, Reclamation Rights in Bankruptcy: Section 503(b)(9) Claim as an Alternative Remedy ([7-506-5441](#))). Counsel for creditors' committees, therefore, became creative and frequently negotiated settlements that involved a senior class of creditors gifting value to the general unsecured creditors by skipping over a higher priority group of impaired creditors. This is what occurred in *Jevic*.

### WHAT HAPPENED IN JEVIC AND WHY DID THE SUPREME COURT TAKE AN INTEREST IN THE CASE?

In 2006, Sun Capital Partners (Sun) acquired Jevic Transportation, Inc. (Jevic) with money borrowed from CIT Group (CIT) in a leveraged buyout (LBO). As is typical in an LBO, Jevic was leveraged with substantial debt and two years later Jevic filed for bankruptcy as it was unable to sustain the high debt burden. The day before filing for bankruptcy, Jevic sent termination notices to its employees. At that time, Jevic owed \$53 million to its senior secured creditors, Sun and CIT, and more than \$20 million to tax and general unsecured creditors.

During Jevic's bankruptcy case, parties filed two adversary proceedings in response to Jevic's bankruptcy filing. First, former truck drivers of Jevic (WARN Act Plaintiffs) filed suit against Jevic and Sun, alleging violations of state and federal Worker Adjustment and Retraining Notifications (WARN) Acts for failure to provide the required 60 days' written notice of termination to the employees. The bankruptcy court granted summary judgment for petitioners and about \$8.3 million of petitioners' judgment constituted a priority wage claim under section 507(a)(4) of the Bankruptcy Code which entitled petitioners to priority over unsecured claims against the Jevic estate.

The second adversary proceeding was brought by a court-authorized committee representing Jevic's unsecured creditors which sued Sun and CIT, alleging that respondents accelerated Jevic's bankruptcy filing by creating unsustainable debts on Jevic. The bankruptcy court

held that petitioners adequately pleaded preferential and fraudulent transfer claims under sections 547 and 548 of the Bankruptcy Code.

In March of 2012, Jevic, the WARN Act Plaintiffs, the creditors' committee, Sun, and CIT met to discuss settlement of the actions. At this time in the bankruptcy case, Jevic had two assets in the estate. The first was \$1.7 million in cash, which was subject to Sun's priority lien, and the second was the fraudulent conveyance claim asserted by the creditors' committee. The WARN Act Plaintiffs did not agree to a settlement, so Jevic, the creditors' committee, Sun, and CIT negotiated a settlement without the WARN ACT Plaintiffs consent. The settlement provided that:

- The bankruptcy court dismisses the fraudulent conveyance action with prejudice.
- CIT must deposit \$2 million into an account that is to be used to pay the committee's legal fees and administrative expenses.
- Sun must assign its lien on Jevic's \$1.7 million to a trust to pay taxes and administrative expenses and then distribute the remainder on a pro rata basis to low-level priority general unsecured creditors, but not to the WARN Act Plaintiffs, which held a mid-level priority wage claim.
- The settling parties must exchange mutual releases.
- Jevic's Chapter 11 case ends in a structured dismissal.

The US Trustee and the WARN Act Plaintiffs objected to the settlement agreement on the grounds that the settlement violated the absolute priority rule because general unsecured creditors were receiving a distribution ahead of the priority wage claim of the WARN Act Plaintiffs, which were not receiving anything under the settlement. The US Trustee also argued, as it had frequently by this point in other cases, that the Bankruptcy Code does not permit structured dismissals, regardless of whether estate assets are being distributed according to the priorities of the Bankruptcy Code.

The bankruptcy court overruled the objections and approved the settlement on the grounds that although the Bankruptcy Code does not expressly authorize structured dismissals, it was justified under the circumstances presented in *Jevic* because of the “dire circumstances” of the case. The bankruptcy court observed that there was “no prospect of a confirmable Chapter 11 plan” and conversion of the case from a Chapter 11 to Chapter 7 leaves the Chapter 7 trustee with no ability to administer the case because all of the cash was subject to Sun's lien. Regarding the specific objection that the settlement violated the absolute priority rule, the bankruptcy court held that the priority scheme does not extend to settlements, only to plans under section 1129. Concluding that the settlement was the best option to wrap up Jevic's Chapter 11 case, the bankruptcy court approved the settlement agreement.

The WARN Act Plaintiffs appealed to the US District Court of Delaware, which affirmed the bankruptcy court's decision. They then appealed to the US Court of Appeals for the Third Circuit, which also affirmed the decisions below. The Third Circuit majority opinion focused on the fact that the absolute priority rule is only embodied in section 1129, which only deals with plans, and therefore concluded that courts may “in rare instances like [those presented in *Jevic*], approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme.” The WARN Act Plaintiffs sought certiorari from the US Supreme Court.

The US Supreme Court granted certiorari on the WARN Act Plaintiffs' question of "[w]hether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme." The answer to this question is in conflict among the circuit courts and the Supreme Court was prepared to render a decision resolving the conflicting opinions. However, after the Supreme Court granted certiorari, the WARN Act Plaintiffs recast the question presented to ask "[w]hether a Chapter 11 case may be terminated by a structured dismissal that distributes estate property in violation of the Bankruptcy Code's priority scheme."

### WHAT DID THE US SUPREME COURT HOLD IN *JEVIC*?

The US Supreme Court overruled the Third Circuit in a 6-2 opinion. The Supreme Court noted that the Bankruptcy Code provides for only three possible outcomes to a Chapter 11 case:

- Confirmation of a plan.
- Conversion of the case to a Chapter 7 proceeding for liquidation of the business and distribution of remaining assets.
- Dismissal of the case.

The Supreme Court found that under the plain language of the Bankruptcy Code only the first two possibilities (a Chapter 11 plan or a Chapter 7 liquidation) explicitly allow for any distribution to creditors and a dismissal does not.

The Court noted that in a Chapter 7 case the absolute priority rule is absolute. Under a Chapter 11 plan, the absolute priority rule provides that a plan cannot be confirmed over the objection of a higher priority impaired creditor. The Court stated that the Bankruptcy Code's priority scheme has "long been considered fundamental to the Bankruptcy Code's operation."

While section 349(b) of the Bankruptcy Code does allow a bankruptcy court to depart from restoring the parties to the prepetition status quo when a dismissal occurs "for cause," the Supreme Court interpreted this as allowing the bankruptcy court to "make the appropriate orders to protect rights acquired in reliance on the bankruptcy case" (*Wiese v. Community Bank of Central Wis.*, 552 F.3d 584, 590 (7th Cir. 2009)). The Supreme Court concluded that there is no authority from Congress or in the Bankruptcy Code supporting that "for cause" encompasses the bankruptcy court approving nonconsensual priority-violating structured dismissals.

The Supreme Court distinguished the priority-violating dismissal in *Jevic* from the priority-deviating settlement approved by the US Court of Appeals for the Second Circuit in *In re Iridium Operating LLC* (478 F.3d 452 (2d Cir. 2007)), on the basis that *Iridium* did not involve a final distribution of estate value. The Supreme Court noted that courts consistently recognize the "Code-related objectives" served by interim, priority-violating distributions, such as first day wage motions and critical vendor motions because they aid a case's ongoing administration and increase the likelihood of a successful reorganization. The Supreme Court differentiated these mid-case, interim priority violating distributions with a priority violating distribution in a final case disposition, which the Supreme Court explains does not:

- Preserve the debtor as a going concern.
- Improve the position of disfavored creditors.
- Promote the possibility of a confirmable plan.

- Help restore the status quo before the petition date.
- Protect reliance interests.

With that analysis, the Supreme Court overruled the Third Circuit's "rare instances" exception and held that a structured dismissal cannot violate the priorities set out in the Bankruptcy Code absent consent of the senior impaired creditor.

The dissent by Justices Thomas and Alito stated that the appeal should be dismissed on procedural grounds because the basis on which certiorari was granted was not the question argued by the WARN Act Plaintiffs.

### WHAT ARE THE IMPLICATIONS OF THE US SUPREME COURT'S *JEVIC* DECISION?

The Supreme Court did not overrule or comment on the construct of structured dismissals. It expressly stated that the Court was not taking a view regarding the general legality of structured dismissals. However, the Court clarified that, absent the consent of any skipped, impaired senior priority creditor, distributions made in the context of a final disposition of case must respect the absolute priority rule, whether these distributions are made in connection with a plan or a structured dismissal.

Structured dismissals are generally used in cases that cannot afford the expense of a plan process. After *Jevic*, parties seeking to end a Chapter 11 case with a structured dismissal must ensure that either:

- Distributions comply with the absolute priority rule.
- The parties obtain the consent of every skipped-over, impaired, senior priority creditor, if the structured dismissal contemplates making distributions that do not respect the absolute priority rule.

The question remains how that consent must be conveyed. Must the consent be express and conveyed in a form of writing or can it be implied by not receiving an objection to the structured dismissal. In some cases it may be practical to obtain express consent, for example, where there are few administrative creditors and a conversion of a case from Chapter 11 to Chapter 7 may result in smaller or no distributions to those administrative creditors. In other cases, where there are many administrative creditors, it may be impractical to obtain the express consent of every skipped, impaired senior priority creditor.

However, the Supreme Court did not address the initial question presented: whether a bankruptcy court may authorize the distribution of settlement proceeds in a manner that violates the statutory priority scheme. This question remains a circuit conflict and the answer may depend on:

- When a settlement is reached (earlier in the case versus later).
- Whether it is known that the case is likely to liquidate or reorganize.

Because the Supreme Court did not take a view on the legality of structured dismissals themselves, that question is also likely to be addressed at another time.

### WHAT ARE YOUR VIEWS ON THE DISSENT OPINION OF JUSTICES THOMAS AND ALITO?

The dissent found that the writ of certiorari should have been dismissed as improvidently granted. The dissent took issue with the fact that the US Supreme Court granted certiorari to decide a

much broader issue of whether the bankruptcy court may authorize the distribution of settlement proceeds that violate the bankruptcy code's priority rules, but then were presented with a much narrower issue of whether a Chapter 11 case may be dismissed by a structured dismissal that is in violation of the Bankruptcy Code's priority rules.

By addressing the narrower issue, the Supreme Court did not have the benefit of views from additional courts of appeals on the issue. The dissent also noted that the Supreme Court was in line to benefit from full, adversarial briefing, which did not occur because the

respondents did not brief the recast question, but rather the original question, according to correct procedure. The dissent was concerned about the precedent the Supreme Court was setting by potentially inviting future petitioners to use a "bait-and-switch" tactic to get the Court to rule on a question other than the question presented.

For all of these reasons, the dissent thought the writ of certiorari should have been dismissed. While the dissent's analysis and reasoning is sound, in respecting the rule of the Supreme Court, the majority wins.

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